

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Dollars in millions except per share amounts

### NOTE 1. Summary of Significant Accounting Policies

*Basis of Presentation* - The consolidated financial statements include the accounts of SBC Communications Inc. and its majority-owned subsidiaries (SBC). SBC's subsidiaries and affiliates operate predominantly in the communications services industry, providing landline and wireless telecommunications services and equipment, directory advertising and cable television services both domestically and worldwide.

SBC's largest subsidiaries are Southwestern Bell Telephone Company (SWBell) providing telecommunications services in Texas, Missouri, Oklahoma, Kansas and Arkansas (five-state area), and Pacific Telesis Group (PAC), providing telecommunications services in California and Nevada. PAC's subsidiaries include Pacific Bell (PacBell, which also includes its subsidiaries) and Nevada Bell. (SWBell, PacBell and Nevada Bell are collectively referred to as the Telephone Companies.)

All significant intercompany transactions are eliminated in the consolidation process. Investments in partnerships, joint ventures and less than majority-owned subsidiaries are principally accounted for under the equity method. Earnings from certain foreign investments accounted for under the equity method are included for periods ended within three months of SBC's year end.

Financial information has been restated to reflect the two-for-one stock split, effected in the form of a stock dividend, declared January 30, 1998 (see Note 15). Certain amounts in prior period financial statements have been reclassified to conform to the current year's presentation.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

*Income Taxes* - Deferred income taxes are provided for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes.

Investment tax credits earned prior to their repeal by the Tax Reform Act of 1986 are amortized as reductions in income tax expense over the lives of the assets which gave rise to the credits.

*Cash Equivalents* - Cash equivalents include all highly liquid investments with original maturities of three months or less.

*Deferred Charges* - Directory advertising costs are deferred until the directory is published and advertising revenues related to these costs are recognized.

*Cumulative Effect of Accounting Change* - Prior to January 1, 1996, Pacific Bell Directory (a subsidiary of PacBell) recognized revenues and expenses related to publishing directories in California using the "amortization" method, under which revenues and expenses were recognized over the lives of the directories, generally one year. Effective January 1, 1996, Pacific Bell Directory changed to the "issue basis" method of accounting, which recognizes the revenues and expenses at the time the related directory is published. The change in methodology was made because the issue basis method is generally followed in

the publishing industry, including Southwestern Bell Yellow Pages, and better reflects the operating activity of the business.

The cumulative after-tax effect of applying the change in method to prior years is recognized as of January 1, 1996 as a one-time, non-cash gain applicable to continuing operations of \$90, or \$0.05 per share. The gain is net of deferred taxes of \$53. Had the current method been applied during 1995, income before extraordinary loss and accounting change would not have been materially affected.

*Property, Plant and Equipment* - Property, plant and equipment is stated at cost. The cost of additions and substantial betterments of property, plant and equipment is capitalized. The cost of maintenance and repairs of property, plant and equipment is charged to operating expenses. Property, plant and equipment is depreciated using straight-line methods over their estimated economic lives, generally ranging from 3 to 50 years. Prior to the discontinuance of regulatory accounting in the third quarter of 1995, SWBell and PacBell computed depreciation using certain straight-line methods and rates as prescribed by regulators. In accordance with composite group depreciation methodology, when a portion of the Telephone Companies' depreciable property, plant and equipment is retired in the ordinary course of business, the gross book value is charged to accumulated depreciation; no gain or loss is recognized on the disposition of this plant.

*Intangible Assets* - Intangible assets consist primarily of wireless cellular and Personal Communications Services (PCS) licenses, television licenses, customer lists and the excess of consideration paid over net assets acquired in business combinations. These assets are being amortized using the straight-line method, over periods generally ranging from 5 to 40 years. At December 31, 1997 and 1996, amounts included in net intangible assets for licenses were \$2,625 and \$2,695. Management periodically reviews the carrying value and lives of all intangible assets based on expected future cash flows.

*Software Costs* - The costs of computer software purchased or developed for internal use are expensed as incurred. However, initial operating system software costs are capitalized and amortized over the lives of the associated hardware.

*Advertising Costs* - Costs for advertising products and services or corporate image are expensed as incurred.

*Foreign Currency Translation* - Local currencies are generally considered the functional currency for SBC's share of foreign operations, except in countries considered highly inflationary. SBC translates its share of foreign assets and liabilities at current exchange rates. Revenues and expenses are translated using average rates during the year. The ensuing foreign currency translation adjustments are recorded as a separate component of Shareowners' Equity. Other transaction gains and losses resulting from exchange rate changes on transactions denominated in a currency other than the local currency are included in earnings as incurred.

*Earnings Per Common Share* - In 1997, Statement of Financial Accounting Standards No. 128, "Earnings per Share" (FAS 128) replaced the calculation of primary and fully diluted earnings per share with basic and diluted earnings per share.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Dollars in millions except per share amounts

Basic earnings per share excludes any dilutive effects of options and other stock-based compensation. All earnings per share amounts for all periods have been presented and, where appropriate, restated to conform to FAS 128 requirements.

*Derivative Financial Instruments* - SBC does not invest in any derivatives for trading purposes. From time to time SBC invests in immaterial amounts of interest rate swaps in order to manage exposure to interest rate risk and foreign currency forward exchange contracts in order to manage exposure to changes in foreign currency rates. Amounts related to derivative contracts are recorded using the hedge accounting approach. SBC currently does not recognize the fair values of these derivative financial investments or their changes in fair value in its financial statements. PAC has entered into an equity swap contract to hedge exposure to risk associated with its recorded liability for certain outstanding employee stock options relating to stock of AirTouch Communications Inc. (see Note 10). The equity swap contract and its liability are recorded at fair value in the balance sheet as other assets or liabilities.

### NOTE 2. Discontinuance of Regulatory Accounting

In the third quarter of 1995, SWBell and PacBell discontinued their application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (FAS 71). FAS 71 requires depreciation of telephone plant using lives set by regulators which are generally longer than those established by unregulated companies and the deferral of certain costs and obligations based on regulatory actions (regulatory assets and liabilities). As a result of the adoption of price-based regulation for most of SWBell's revenues and the acceleration of competition in the California and five-state area telecommunications markets, management determined that SWBell and PacBell no longer met the criteria for application of FAS 71.

Upon discontinuance of FAS 71 by SWBell and PacBell, SBC recorded a non-cash, extraordinary charge to net income of \$6,022 (after a net deferred tax benefit of \$4,037). This charge was comprised of an after-tax charge of \$5,739 to reduce the net carrying value of telephone plant, and an after-tax charge of \$283 for the elimination of net regulatory assets. The components of the charge were as follows:

	Pre-tax	After-tax
Increase telephone plant accumulated depreciation	\$ 9,476	\$5,739
Elimination of net regulatory assets	583	283
Total	\$10,059	\$6,022

The increase in accumulated depreciation of \$9,476 reflected the effects of adopting depreciable lives for SWBell's and PacBell's plant categories which more closely reflect the economic and technological lives of the plant. The adjustment was supported by discounted cash flow analyses, that estimated amounts of telephone plant that may not be recoverable from discounted future cash flows. These analyses included consideration of the effects of anticipated competition and technological changes on plant lives and revenues.

Following is a comparison of new lives to those prescribed by regulators for selected plant categories:

	Average Lives (in Years)	
	Regulator-Prescribed	Estimated Economic
Digital switch	17	10-11
Digital circuit	10-12	7-8
Copper cable	19-26	14-18
Fiber cable	27-30	20
Conduit	57-59	50

The increase in accumulated depreciation at SWBell also included an adjustment of approximately \$450 to fully depreciate analog switching equipment scheduled for replacement. Remaining analog switching equipment is being depreciated using an average remaining life of four years.

The discontinuance of FAS 71 for external financial reporting purposes also required the elimination of net regulatory assets of \$583. Regulatory assets and liabilities are related primarily to accounting policies used by regulators in the rate-making process which are different from those used by non-regulated companies. The differences arose predominantly in the accounting for income taxes, deferred compensated absences, and in California, pension costs and debt redemption costs. These items were required to be eliminated with the discontinuance of accounting under FAS 71. SWBell and PacBell accounting and reporting for regulatory purposes are not affected by the discontinuance of FAS 71 for external financial reporting purposes.

With the discontinuance of FAS 71, SWBell and PacBell began accounting for interest on funds borrowed to finance construction as an increase in property, plant and equipment and a reduction of interest expense. Under the provisions of FAS 71, both companies capitalized both interest and equity costs allowed by regulators during periods of construction as other income and as an addition to the cost of plant constructed. Additionally, PacBell began accounting for pension costs under Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions," (FAS 87) and Statement of Financial Accounting Standards No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" (FAS 88).

### NOTE 3. Merger with PAC

On April 1, 1997, SBC and PAC completed the merger of an SBC subsidiary with PAC, in a transaction in which each share of PAC common stock was exchanged for 1.4629 shares of SBC common stock (equivalent to approximately 626 million shares; both the exchange ratio and shares issued have been restated to reflect the two-for-one stock split declared January 30, 1998). With the merger, PAC became a wholly-owned subsidiary of SBC. The transaction has been accounted for as a pooling of interests and a tax-free reorganization. Accordingly, the financial statements for the periods presented prior to the merger have been restated to include the accounts of PAC.

Operating revenues, income before extraordinary loss and cumulative effect of accounting change and net income (loss) of the separate companies for the pre-merger periods of the last three years were as follows:

	Three months ended March 31,	Year Ended December 31,	
	1997	1996	1995
Operating revenues:			
SBC	\$3,456	\$13,857	\$12,670
PAC	2,535	9,588	9,042
Combined	\$5,991	\$23,445	\$21,712
Income before extraordinary loss and cumulative effect of accounting change:			
SBC	\$ 517	\$ 2,101	\$ 1,889
PAC	352	1,057	1,048
Adjustments	(12)	31	21
Combined	\$ 857	\$ 3,189	\$ 2,958
Net income (loss):			
SBC	\$ 517	\$ 2,101	\$ (930)
PAC	352	1,142	(2,312)
Adjustments	(12)	36	178
Combined	\$ 857	\$ 3,279	\$ (3,064)

The combined results include the effect of changes applied retroactively to conform accounting methodologies between PAC and SBC for, among other items, pensions, postretirement benefits, sales commissions and merger transaction costs as well as certain deferred tax adjustments resulting from the merger. In each case, SBC believes the new methods are more prevalent and better reflect the operations of the business. Transaction costs and one-time charges relating to the closing of the merger were \$359 (\$215 net of tax) including, among other items, the present value of amounts to be returned to California ratepayers as a condition of the merger and expenses for investment banker and professional fees. Of this total, \$287 (\$180 net of tax) is included in expenses in 1997, and \$72 (\$35 net of tax) in 1996.

#### *Post-merger initiatives*

During the second quarter of 1997, SBC announced after-tax charges of \$1.6 billion related to several strategic decisions resulting from the merger integration process that began with the April 1 closing of its merger with PAC, which included \$165 (\$101 after tax) of charges related to several regulatory rulings during the second quarter of 1997 and \$281 (\$176 after tax) for merger approval costs. The decisions resulted from an extensive review of operations throughout the merged company and include significant integration of operations and consolidation of some administrative and support functions. Following is a discussion of the most significant of these charges.

**Reorganization** SBC is centralizing several key functions that will support the operations of the Telephone Companies, including network planning, strategic marketing and procurement. It is also consolidating a number of corporate-wide support activities, including research and development, infor-

mation technology, financial transaction processing and real estate management. The Telephone Companies will continue as separate legal entities. These initiatives will result in the creation of some jobs and the elimination and realignment of others, with many of the affected employees changing job responsibilities and in some cases assuming positions in other locations.

SBC recognized a charge of approximately \$338 (\$213 net of tax) during the second quarter of 1997 in connection with these initiatives. This charge was comprised mainly of postemployment benefits, primarily related to severance, and costs associated with closing down duplicate operations, primarily contract cancellations. Other charges arising out of the merger related to relocation, retraining and other effects of consolidating certain operations are being recognized in the periods those charges are incurred. During the second half of 1997, SBC incurred \$501 (\$304 net of tax) of merger-related charges.

**Impairments/asset valuation** As a result of SBC's merger integration plans, strategic review of domestic operations and organizational realignments, SBC reviewed the carrying values of related long-lived assets. This review included estimating remaining useful lives and cash flows and identifying assets to be abandoned. Where this review indicated impairment, discounted cash flows related to those assets were analyzed to determine the amount of the impairment. As a result of these reviews, SBC wrote off some assets and recognized impairments to the value of other assets with a combined charge of \$965 (\$667 after tax) recorded in the second quarter of 1997. These impairments and writeoffs related to the wireless digital TV operations in southern California, certain analog switching equipment in California, certain rural and other telecommunications equipment in Nevada, selected wireless equipment, duplicate or obsolete equipment, cable within commercial buildings in California, certain nonoperating plant and other assets.

**Video curtailment/purchase commitments** SBC also announced that it is scaling back its limited direct investment in video services. As a result of this curtailment, SBC has halted construction on the Advanced Communications Network (ACN) in California. As part of an agreement with the ACN vendor, SBC paid the liabilities of the ACN trust that owned and financed ACN construction, incurred costs to shut down all construction previously conducted under the trust and received certain consideration from the vendor. In the second quarter of 1997, SBC recognized its net expense of \$553 (\$346 after tax) associated with these activities. Additionally, SBC curtailed several other video-related activities including discontinuing its broadband network video trials in Richardson, Texas and San Jose, California, substantially scaling back its involvement in the Tele-TV joint venture and withdrawing from the Americast venture. Americast partners are disputing the withdrawal in arbitration and litigation, the outcome of which cannot be predicted. The collective impact of these decisions resulted in a charge of \$145 (\$92 after tax) in the second quarter of 1997.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Dollars in millions except per share amounts

## NOTE 4. Merger Agreement with Southern New England Telecommunications Corporation (SNET)

On January 5, 1998, SBC and SNET jointly announced a definitive agreement to merge an SBC subsidiary with SNET, in a transaction in which each share of SNET common stock will be exchanged for 1.7568 shares of SBC common stock (equivalent to approximately 120 million shares, or 6.5% of SBC's outstanding shares at December 31, 1997; both the exchange ratio and shares to be issued have been restated to reflect the two-for-one stock split declared January 30, 1998). After the merger, SNET will be a wholly-owned subsidiary of SBC. The transaction is intended to be accounted for as a pooling of interests and to be a tax-free reorganization. The merger is subject to certain regulatory approvals as well as approval by the shareowners of SNET at a special meeting expected to be held on March 27, 1998. If approvals are granted, the transaction is expected to close by the end of 1998.

## NOTE 5. Pacific Telesis Group Financial Information

The following table presents summarized financial information for Pacific Telesis Group at December 31, or for the year then ended:

	1997	1996	1995
<b>Balance Sheets</b>			
Current assets	\$ 2,835	\$ 2,474	\$ 2,434
Noncurrent assets	14,041	14,134	13,407
Current liabilities	4,513	3,527	4,641
Noncurrent liabilities	10,305	10,308	9,010
<b>Income Statements</b>			
Operating revenues	\$10,101	\$ 9,588	\$ 9,042
Operating income (loss)	(166)	2,198	2,011
Income (loss) before extraordinary loss and cumulative effect of accounting changes	(546)	1,057	1,048
Net income (loss)	(224)	1,142	(2,312)

SBC has not provided separate financial statements and other disclosures for PAC as management has determined that such information is not material to the holders of the Trust Originated Preferred Securities (TOPrS) (see Note 10). On January 30, 1998, SBC guaranteed payment of the obligations of the TOPrS.

## NOTE 6. Earnings Per Share

A reconciliation of the numerators and denominators of basic earnings per share and diluted earnings per share for income before extraordinary loss and cumulative effect of accounting change for the years ended December 31, 1997, 1996 and 1995 are shown in the table below. Per share amounts have been restated to reflect the two-for-one stock split declared January 30, 1998.

Year Ended December 31,	1997	1996	1995
<b>Numerators</b>			
Numerator for basic earnings per share:			
Income before extraordinary loss and cumulative effect of accounting change	\$1,474	\$3,189	\$2,958
Dilutive potential common shares:			
Other stock-based compensation	3	2	2
Numerator for diluted earnings per share	\$1,477	\$3,191	\$2,960
<b>Denominators</b>			
Denominator for basic earnings per share:			
Weighted average number of common shares outstanding (000)	1,828,395	1,841,240	1,840,861
Dilutive potential common shares (000):			
Stock options	11,791	6,783	4,910
Other stock-based compensation	4,443	3,410	2,936
Denominator for diluted earnings per share	1,844,629	1,851,433	1,848,707
<b>Basic earnings per share:</b>			
Income before extraordinary loss and cumulative effect of accounting change	\$ 0.81	\$ 1.73	\$ 1.61
Extraordinary loss	-	-	(3.27)
Cumulative effect of accounting change	-	0.05	-
Net income (loss)	\$ 0.81	\$ 1.78	\$ (1.66)
<b>Diluted earnings per share:</b>			
Income before extraordinary loss and cumulative effect of accounting change	\$ 0.80	\$ 1.72	\$ 1.60
Extraordinary loss	-	-	(3.26)
Cumulative effect of accounting change	-	0.05	-
Net income (loss)	\$ 0.80	\$ 1.77	\$ (1.66)

## NOTE 7. Property, Plant and Equipment

Property, plant and equipment is summarized as follows at December 31:

	1997	1996
<b>Telephone Companies plant</b>		
In service	\$ 60,122	\$ 56,638
Under construction	1,147	1,614
	61,269	58,252
Accumulated depreciation and amortization	(36,384)	(34,515)
Total Telephone Companies	24,885	23,737
<b>Other</b>		
Accumulated depreciation and amortization	(1,563)	(1,191)
Total other	2,454	2,343
Property, plant and equipment-net	\$ 27,339	\$ 26,080

SBC's depreciation expense as a percentage of average depreciable plant was 7.4% for 1997, 6.9% for 1996 and 7.0% for 1995.

Certain facilities and equipment used in operations are under operating or capital leases. Rental expenses under operating leases for 1997, 1996 and 1995 were \$390, \$324 and \$231. At December 31, 1997, the future minimum rental payments under noncancelable operating leases for the years 1998 through 2002 were \$168, \$171, \$113, \$86 and \$66, and \$238 thereafter. Capital leases were not significant.

#### NOTE 8. Equity investments

Investments in affiliates accounted for under the equity method include SBC's investment in Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company. SBC is a member of a consortium that holds all of the AA shares of Telmex stock, representing voting control of the company. The consortium is controlled by a group of Mexican investors led by an affiliate of Grupo Carso, S.A. de C.V. SBC also owns L shares which have limited voting rights. Throughout 1997 and in February 1998, SBC sold portions of its L shares so that its total equity investment remained below 10% of Telmex's total equity capitalization.

Other major equity investments held by SBC include a 1997 investment of \$760 in South African telecommunications (see Note 16), an indirect 15% ownership in Cegetel, a joint venture providing a broad range of telecommunications offerings in France, investments in Chilean telecommunications operations and minority ownership of several domestic wireless properties.

The following table is a reconciliation of SBC's investments in equity affiliates:

	1997	1996	1995
Beginning of year	\$1,964	\$1,616	\$1,776
Additional investments	1,076	337	447
Equity in net income	201	207	120
Dividends received	(90)	(70)	(62)
Currency translation adjustments	(135)	(94)	(268)
Reclassifications and other adjustments	(276)	(32)	(397)
End of year	\$2,740	\$1,964	\$1,616

Currency translation adjustments for 1997 primarily reflect the effect of the exchange rate fluctuations on SBC's investments in South African and French telecommunications.

The currency translation adjustment for 1995 primarily reflects the effect on SBC's investment in Telmex of the decline in the value of the Mexican peso relative to the U.S. dollar during 1995. In 1997, SBC used the U.S. dollar, instead of the peso, as the functional currency for its investment in Telmex due to the Mexican economy becoming highly inflationary.

Other adjustments for 1997 reflect the sale of portions of SBC's Telmex L shares and the change to the cost method of accounting in 1997 for SBC's 1995 investment in South African wireless operations. Other adjustments for 1995 reflect the change in October 1995 to the cost method of accounting for SBC's United Kingdom cable television operations (see Note 16).

Undistributed earnings from equity affiliates were \$862 and \$762 at December 31, 1997 and 1996.

#### NOTE 9. Debt

Long-term debt, including interest rates and maturities, is summarized as follows at December 31:

	1997	1996
<b>SWBell</b>		
Debentures		
4.50%-5.88% 1997-2006	\$ 500	\$ 600
6.13%-6.88% 2000-2024	1,550	1,200
7.00%-7.75% 2009-2027	1,750	1,500
	3,800	3,300
Unamortized discount-net of premium	(36)	(29)
Total debentures	3,764	3,271
Notes		
5.04%-7.67% 1997-2010	1,236	1,118
Unamortized discount	(6)	(6)
Total notes	1,230	1,112
<b>PacBell</b>		
Debentures		
4.62%-5.88% 1999-2006	475	475
6.00%-6.88% 2002-2034	1,194	1,194
7.12%-7.75% 2008-2043	2,250	2,150
8.50% 2031	225	225
	4,144	4,044
Unamortized discount-net of premium	(89)	(89)
Total debentures	4,055	3,955
Notes		
6.25%-8.70% 2001-2009	1,300	1,150
Unamortized discount	(18)	(18)
Total notes	1,282	1,132
<b>Other notes</b>		
5.76%-6.98% 1997-2007	188	310
7.00%-9.50% 1997-2020	1,318	1,140
	1,506	1,450
Unamortized premium (discount)	71	(14)
Total other notes	1,577	1,436
<b>Guaranteed obligations of employee stock ownership plans<sup>(1)</sup></b>		
8.41%-9.40% 1997-2000	153	208
<b>Capitalized leases</b>	294	303
<b>Total long-term debt, including current maturities</b>	12,355	11,417
<b>Current maturities</b>	(336)	(487)
<b>Total long-term debt</b>	<b>\$12,019</b>	<b>\$10,930</b>

<sup>(1)</sup>See Note 13.

In February 1998, SBC called \$630 of debentures and notes of SWBell, PacBell and SBC Communications Capital Corporation (included in Other notes). Estimated net income impact from unamortized discounts and call premiums is \$(8). During 1995, SBC refinanced long-term debentures of SWBell and PacBell. Costs of \$36 associated with refinancing are included in other income (expense) - net, with related income tax benefits of \$14 included in income taxes in SBC's Consolidated Statements of Income.

At December 31, 1997, the aggregate principal amounts of long-term debt scheduled for repayment for the years 1998

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through 2002 were \$336, \$500, \$469, \$986 and \$879. As of December 31, 1997, SBC was in compliance with all covenants and conditions of instruments governing its debt.

Debt maturing within one year consists of the following at December 31:

	1997	1996
Commercial paper	\$1,268	\$1,848
Current maturities of long-term debt	336	487
Other short-term debt	349	-
Total	\$1,953	\$2,335

The weighted average interest rate on commercial paper debt at December 31, 1997 and 1996 was 6.0%. SBC has entered into agreements with several banks for lines of credit totaling \$1,000. All of these agreements may be used to support commercial paper borrowings and are on a negotiated fee basis with interest rates negotiable at time of borrowing. There were no borrowings outstanding under these lines of credit at December 31, 1997. Another group of uncommitted lines of credit with banks that do not require compensating balances or commitment fees, and accordingly are subject to continued review, amounted to approximately \$1,475 at December 31, 1997.

## NOTE 10. Financial Instruments

The carrying amounts and estimated fair values of SBC's long-term debt, including current maturities and other financial instruments, are summarized as follows at December 31:

	1997		1996	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
SWBell debentures	\$3,764	\$3,828	\$3,271	\$3,208
SWBell notes	1,230	1,271	1,112	1,115
PacBell debentures	4,055	4,337	3,955	3,917
PacBell notes	1,282	1,342	1,132	1,171
Other notes	1,577	1,768	1,436	1,478
TOPrS	1,000	1,034	1,000	990
Guaranteed obligations of employee stock ownership plans <sup>(1)</sup>	153	159	208	219

<sup>(1)</sup>See Note 13.

The fair values of SBC's long-term debt were estimated based on quoted market prices, where available, or on the net present value method of expected future cash flows using current interest rates. The fair value of the TOPrS was estimated based on quoted market prices. The carrying amounts of commercial paper debt approximate fair values.

SBC does not hold or issue any financial instruments for trading purposes. SBC's cash equivalents and short-term investments are recorded at amortized cost. The carrying amounts of cash and cash equivalents and short-term investments and customer deposits approximate fair values.

Pacific Telesis Financing I and II (the Trusts) were formed for the exclusive purpose of issuing preferred and common securities representing undivided beneficial interests in the Trusts and investing the proceeds from the sales of TOPrS in unsecured subordinated debt securities of PAC. Under certain circumstances, dividends on TOPrS could be deferred for up to a

period of five years. PAC sold \$1 billion of TOPrS, \$500 at 7.56% in January 1996 through Pacific Telesis Financing I and \$500 at 8.5% in June 1996 through Pacific Telesis Financing II. As of December 31, 1997, the Trusts held subordinated debt securities of PAC in principal amounts of \$516 and \$514 with interest rates of 7.56% and 8.5%. Both issues of TOPrS were priced at \$25 per share, have an original 30-year maturity that may be extended up to 49 years, and are callable five years after date of sale at par and are included on the balance sheet as corporation-obligated mandatorily redeemable preferred securities of subsidiary trusts. The proceeds were used to retire short-term indebtedness, primarily commercial paper. On January 30, 1998, SBC guaranteed payment of the obligations of the TOPrS.

**Derivatives** PAC has entered into an equity swap contract to hedge exposure to risk of market changes related to its recorded liability for outstanding employee stock options for common stock of AirTouch Communications, Inc. (spun-off operations) and associated stock appreciation rights (SARs) (see Note 14). PAC plans to make open market purchases of the stock of spun-off operations to satisfy its obligation for options that are exercised. Off-balance-sheet risk exists to the extent the market price of the stock of spun-off operations rises above the market price reflected in the liability's current carrying value. The equity swap was entered into to hedge this exposure and minimize the impact of market fluctuations. The contract entitles PAC to receive settlement payments to the extent the price of the common stock of spun-off operations rises above the notional value of \$23.74 per share, but imposes an obligation to make payments to the extent the price declines below this level. The swap also obligates PAC to make a monthly payment of a fee based on LIBOR. The total notional amount of the contract, \$32 and \$60 as of December 31, 1997 and 1996 covers the approximate number of the outstanding options and SARs of spun-off operations on that date. PAC plans to periodically adjust downward the outstanding notional amount as the options and SARs are exercised. The equity swap contract expires April 1999.

Both the equity swap and PAC's liability for the stock options and SARs of spun-off operations are carried in the balance sheet at their market values, which were immaterial as of December 31, 1997 and 1996. Gains and losses from quarterly market adjustments of the carrying amounts substantially offset. As of December 31, 1997 and 1996, the accounting loss that would be incurred from nonperformance by the counterparty to the equity swap was \$14 and \$4. However, management does not expect to realize any loss from counterparty nonperformance.

# NOTE 11. Income Taxes

Significant components of SBC's deferred tax liabilities and assets are as follows at December 31:

	1997	1996
Depreciation and amortization	\$3,648	\$3,283
Other	2,255	1,017
Deferred tax liabilities	5,903	4,300
Employee benefits	2,391	2,221
Unamortized investment tax credits	169	195
Other	2,394	1,328
Deferred tax assets	4,954	3,744
Deferred tax assets valuation allowance	68	96
Net deferred tax liabilities	\$1,017	\$ 652

The decrease in the valuation allowance is the result of an evaluation of the uncertainty associated with the realization of certain deferred tax assets. The valuation allowance is maintained in deferred tax assets for certain unused federal and state loss carryforwards.

The components of income tax expense are as follows:

	1997	1996	1995
Federal			
Current	\$705	\$1,242	\$ 829
Deferred-net	57	468	520
Amortization of investment tax credits	(81)	(80)	(95)
	681	1,630	1,254
State and local			
Current	24	172	176
Deferred-net	158	158	89
	182	330	265
Total	\$863	\$1,960	\$1,519

A reconciliation of income tax expense and the amount computed by applying the statutory federal income tax rate (35%) to income before income taxes, extraordinary loss and cumulative effect of accounting change is as follows:

	1997	1996	1995
Taxes computed at federal statutory rate	\$818	\$1,802	\$1,567
Increases (decreases) in income taxes resulting from:			
Amortization of investment tax credits over the life of the plant that gave rise to the credits	(53)	(53)	(92)
State and local income taxes - net of federal income tax benefit	118	215	172
Other - net	(20)	(4)	(128)
Total	\$863	\$1,960	\$1,519

# NOTE 12. Employee Benefits

*Pensions* - Substantially all employees of SBC are covered by one of three noncontributory pension and death benefit plans. The pension benefit formula used in the determination of pension cost for nonmanagement employees is based on a

flat dollar amount per year of service according to job classification. For PAC managers, benefits accrue in separate account balances based on a fixed percentage of each employee's monthly salary with interest. For all other managers, benefits accrue in separate account balances based on a fixed percentage of each employee's monthly salary plus interest or are determined based upon a stated percentage of adjusted career income.

SBC's objective in funding the plans, in combination with the standards of the Employee Retirement Income Security Act of 1974 (as amended), is to accumulate funds sufficient to meet its benefit obligations to employees upon their retirement. Contributions to the plans are made to a trust for the benefit of plan participants. Plan assets consist primarily of stocks, U.S. government and domestic corporate bonds, index funds and real estate.

Net pension cost is composed of the following:

	1997	1996	1995
Service cost-benefits earned during the period	\$ 278	\$ 297	\$ 311
Interest cost on projected benefit obligation	1,146	1,131	1,161
Actual return on plan assets	(3,775)	(2,919)	(4,232)
Other-net	2,161	1,270	2,813
Net pension cost (benefit)	\$ (190)	\$ (221)	\$ 53

The following table sets forth the pension plans' funded status and the amounts included in SBC's Consolidated Balance Sheets at December 31:

	1997	1996
Fair value of plan assets	\$23,092	\$20,738
Less: Actuarial present value of projected benefit obligation	16,746	15,006
Plan assets in excess of projected benefit obligation	6,346	5,732
Unrecognized prior service cost	1,108	845
Unrecognized net gain	(6,564)	(6,072)
Unamortized transition asset	(811)	(973)
Prepaid (accrued) pension cost	\$ 79	\$ (468)

The projected benefit obligation was increased \$202 at December 31, 1996, for the cost of force reductions anticipated to take place in 1996 and 1997 and recognized in SBC's financial statements under FAS 88.

Significant weighted average assumptions used in developing pension information include:

	1997	1996	1995
Discount rate for determining projected benefit obligation	7.25%	7.5%	7.25%
Long-term rate of return on plan assets	8.5%	8.55%	8.0%
Composite rate of compensation increase	4.3%	4.3%	4.3%

The projected benefit obligation is the actuarial present value of all benefits attributed by the pension benefit formula to previously rendered employee service. It is measured based on assumptions concerning future interest rates and employee compensation levels. Should actual experience differ from the actuarial assumptions, the benefit obligation will be affected.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Dollars in millions except per share amounts

In April 1997 management amended the pension plan for non-PAC managers to a cash balance pension plan effective June 1, 1997. Under the new plan, participants accrue benefits based on a percentage of pay plus interest. In addition, a transition benefit is phased in over five years. The new plan also requires computation of a grandfathered benefit using the old formula for five years. Participants receive the greater of the cash balance benefit or the grandfathered benefit. The new cash balance plan allows lump sum benefit payments in addition to annuities. This change did not have a significant impact on SBC's net income for 1997.

In March 1996, management amended the pension plan for PAC managers from a final pay plan to a cash balance plan effective July 1, 1996. An enhanced transition benefit, based on frozen pay and service as of June 30, 1996, was established to preserve benefits already accrued by salaried employees under the final pay plan and resulted in an increase in earned benefits for most employees. SBC also updated the actuarial assumptions used in valuing the PAC plans to reflect changes in market interest rates and recent experience, including a change in its assumption concerning future ad hoc increases in pension benefits. Taken together, these changes increased net income by approximately \$125 during 1996.

The actuarial estimate of the accumulated benefit obligation does not include assumptions about future compensation levels. The accumulated benefit obligation as of December 31, 1997 was \$15,565, of which \$14,404 was vested. At December 31, 1996 these amounts were \$13,965 and \$12,376.

Approximately 4,200 and 2,200 employees left PacBell during 1996 and 1995 under retirement or voluntary and involuntary severance programs and received special pension benefits and cash incentives in connection with the PacBell restructuring and related force reduction programs. Annual pension cost excludes \$(64) and \$219 of additional pension costs charged to PacBell's restructuring reserve in 1996 and 1995.

During 1997, the significant amount of lump sum pension payments resulted in a partial settlement of PAC's pension plans. In accordance with FAS 88, net settlement gains in the amount of \$299 were recognized in 1997. Of this amount, \$152 was recognized in the first quarter of 1997 and related primarily to managers who terminated employment in 1996. These gains are not included in the net pension cost shown in the preceding table.

In December 1996, under the provisions of Section 420 of the Internal Revenue Code, SBC transferred \$73 in pension assets to a health care benefit account for the reimbursement of retiree health care benefits paid by SBC. No additional pension assets were transferred to the health care benefit account in 1997.

**Supplemental Retirement Plans** - SBC also provides senior and middle management employees with nonqualified, unfunded supplemental retirement and savings plans. These plans include supplemental defined pension benefits as well as compensation deferral plans, some of which include a corresponding match by SBC based on a percentage of the compensation deferral. Expenses related to these plans were \$89, \$88

and \$91 in 1997, 1996 and 1995. Liabilities of \$892 and \$758 related to these plans have been included in other noncurrent liabilities in SBC's Consolidated Balance Sheets at December 31, 1997 and 1996.

**Postretirement Benefits** - SBC provides certain medical, dental and life insurance benefits to substantially all retired employees under various plans and accrues actuarially determined postretirement benefit costs as active employees earn these benefits. Employees retiring after certain dates will pay a share of the costs of medical coverage that exceed a defined dollar medical cap. Such future cost sharing provisions have been reflected in determining SBC's postretirement benefit costs.

Postretirement benefit cost is composed of the following:

	1997	1996	1995
Service cost-benefits earned during the period	\$102	\$101	\$ 99
Interest cost on accumulated postretirement benefit obligation (APBO)	480	475	496
Actual return on assets	(619)	(375)	(452)
Other-net	398	208	318
Postretirement benefit cost	\$361	\$409	\$461

SBC maintains Voluntary Employee Beneficiary Association (VEBA) trusts to fund postretirement benefits. During 1997 and 1996, SBC contributed \$415 and \$320 into the VEBA trusts to be ultimately used for the payment of postretirement benefits. Assets consist principally of stocks and U.S. government and corporate bonds.

The following table sets forth the plans' funded status and the amount included in SBC's Consolidated Balance Sheets at December 31:

	1997	1996
Retirees	\$4,470	\$4,047
Fully eligible active plan participants	773	706
Other active plan participants	1,932	1,819
Total APBO	7,175	6,572
Less: Fair value of plan assets	3,533	2,697
APBO in excess of plan assets	3,642	3,875
Unrecognized prior service cost	24	(31)
Unrecognized net gain	1,105	1,119
Accrued postretirement benefit obligation	\$4,771	\$4,963

In December 1995, one of the life insurance benefit plans was merged with one of the medical plans. The fair value of plan assets restricted to the payment of life insurance benefits only was \$887 and \$746 at December 31, 1997 and 1996. At December 31, 1997 and 1996, the accrued life insurance benefits included in the accrued postretirement benefit obligation were \$74 and \$57.

The assumed medical cost trend rate in 1998 is 7.5%, decreasing gradually to 5.5% in 2002, prior to adjustment for cost-sharing provisions of the plan for active and certain recently retired employees. The assumed dental cost trend rate in 1998 is 6%, reducing to 5% in 2002. Raising the annual medical and dental cost trend rates by one percentage point increases the APBO as of December 31, 1997 by \$458 and increases the aggregate service and interest cost components of the net periodic postretirement benefit cost for 1997 by



approximately \$45. Significant assumptions for the discount rate, long-term rate of return on plan assets and composite rate of compensation increase used in developing the APBO and related postretirement benefit costs were the same as those used in developing the pension information.

#### NOTE 13. Other Employee Benefits

*Employee Stock Ownership Plans* - SBC maintains contributory savings plans which cover substantially all employees. Under the savings plans, SBC matches a stated percentage of eligible employee contributions, subject to a specified ceiling.

SBC has three leveraged Employee Stock Ownership Plans (ESOPs) as part of the existing savings plans. Two of the ESOPs were funded with notes issued by the savings plans to various lenders, the proceeds of which were used to purchase shares of SBC's common stock in the open market. These notes are unconditionally guaranteed by SBC and therefore presented as a reduction to shareowners' equity and an increase in long-term debt. They will be repaid with SBC contributions to the savings plans, dividends paid on SBC shares and interest earned on funds held by the ESOPs.

The third ESOP purchased PAC treasury shares in exchange for a promissory note from the plan to PAC. Since PAC is the lender, this note is not reflected as a liability and the remaining cost of unallocated trust shares is carried as a reduction of shareowners' equity. Principal and interest on the note are paid from employer contributions and dividends received by the trust. All PAC shares were exchanged for SBC shares effective with the merger April 1, 1997. The provisions of this ESOP were unaffected by this exchange.

SBC's match of employee contributions to the savings plans is fulfilled with shares of stock allocated from the ESOPs and with purchases of SBC's stock in the open market. Shares held by the ESOPs are released for allocation to the accounts of employees as employer matching contributions are earned. Benefit cost is based on a combination of the contributions to the savings plans and the cost of shares allocated to participating employees' accounts. Both benefit cost and interest expense on the notes are reduced by dividends on SBC's shares held by the ESOPs and interest earned on the ESOPs' funds.

Information related to the ESOPs and the savings plans is summarized below:

	1997	1996	1995
Benefit expense-net of dividends and interest income	\$46	\$ 65	\$ 66
Interest expense-net of dividends and interest income	18	26	37
Total expense	\$64	\$ 91	\$103
Company contributions for ESOPs	\$98	\$108	\$ 89
Dividends and interest income for debt service	\$58	\$ 62	\$ 72

SBC shares held by the ESOPs are summarized as follows at December 31:

	1997	1996
Unallocated	15,621,250	31,005,792
Committed to be allocated	282,388	355,188
Allocated to participants	43,151,816	31,119,148
Total	59,055,454	62,480,128

#### NOTE 14. Stock-Based Compensation

Under various SBC plans, senior and other management employees and non-employee directors have received stock options, SARs, performance shares and nonvested stock units to purchase shares of SBC common stock. Options issued through December 31, 1997 carry exercise prices equal to the market price of the stock at the date of grant and have maximum terms ranging from five to ten years. Depending upon the grant, vesting of options may occur up to four years from the date of grant. Performance shares are granted to key employees in the form of common stock and/or in cash based upon the price of common stock at date of grant and are awarded at the end of a two or three year period, subject to the achievement of certain performance goals. Nonvested stock units are also valued at market price of the stock at date of grant and vest over a three-year period. Up to 156 million shares may be issued under these plans.

In 1996 SBC elected to continue measuring compensation cost for these plans using the intrinsic value-based method of accounting prescribed in Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123). Accordingly, no compensation cost for SBC's stock option plans has been recognized. The compensation cost that has been charged against income for SBC's other stock-based compensation plans, primarily SARs and nonvested stock units, totaled \$43, \$22 and \$24 for 1997, 1996 and 1995. Had compensation cost for stock option plans been recognized using the fair-value based method of accounting at the date of grant for awards in 1997, 1996 and 1995 as defined by FAS 123, SBC's net income (loss) would have been \$1,400, \$3,250 and \$(3,074) and basic net income (loss) per share would have been \$0.77, \$1.77 and \$(1.67).

Options and SARs held by the continuing employees of PAC at the time of the AirTouch Communications Inc. spin-off were supplemented with an equal number of options and SARs for common shares of spun-off operations. The exercise prices for outstanding options and SARs held by continuing employees of PAC were adjusted downward to reflect the value of the supplemental spun-off operations' options and SARs. The balance sheet reflects a related liability equal to the difference between the current market price of spun-off operations stock and the exercise prices of the supplemental options outstanding (see Note 10). As of December 31, 1997, 831,139 supplemental spun-off operations options and SARs were outstanding with expiration dates ranging from 1998 to 2003. Outstanding options and SARs that were held by employees of the wireless operations at the spin-off date were replaced by options and SARs for common shares of spun-off operations. The spun-off operations assumed liability for these replacement options and SARs.

For purposes of these pro forma disclosures, the estimated fair value of the options granted after 1994 is amortized to expense over the options' vesting period. Because most employee options vest over a two- to three-year period, these disclosures will not be indicative of future pro forma amounts until the FAS 123 rules are applied to all outstanding

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Dollars in millions except per share amounts

non-vested awards. The fair value for these options was estimated at the date of grant, using a Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1997, 1996 and 1995: risk-free interest rate of 6.57%, 6.26% and 6.34%; dividend yield of 2.99%, 4.92% and 3.61%; expected volatility factor of 15%, 18% and 18%; and expected option life of 5.8, 4.7 and 4.6 years.

Information related to options and SARs is summarized below and has been restated to reflect the two-for-one stock split declared January 30, 1998:

	Number	Weighted Average Exercise Price
Outstanding at January 1, 1995	43,988,164	\$19.52
Granted	16,735,644	23.49
Exercised	(4,373,340)	16.90
Forfeited/Expired	(1,509,368)	21.36
Outstanding at December 31, 1995 (25,524,518 exercisable at weighted average price of \$19.05)	54,841,100	20.89
Granted	24,643,276	22.98
Exercised	(3,767,420)	18.73
Forfeited/Expired	(1,518,552)	21.56
Outstanding at December 31, 1996 (35,522,826 exercisable at weighted average price of \$20.13)	74,198,404	21.68
Granted	32,034,238	27.58
Exercised	(17,118,968)	20.52
Forfeited/Expired	(4,441,532)	25.49
Outstanding at December 31, 1997 (40,802,392 exercisable at weighted average price of \$21.02)	84,672,142	\$23.95

Information related to options and SARs outstanding at December 31, 1997:

	\$12.00	\$12.50	\$20.00	\$22.50
Exercise Price Range	-12.49	-19.99	-22.49	-29.19
Number of options and SARs:				
Outstanding	67,560	9,877,430	18,978,694	55,748,458
Exercisable	67,560	9,877,430	18,944,252	11,913,150
Weighted average exercise price:				
Outstanding	\$ 12.08	\$ 17.50	\$ 20.92	\$ 26.13
Exercisable	\$ 12.08	\$ 17.50	\$ 20.92	\$ 24.14
Weighted average remaining contractual life	0.8 year	5.9 years	6.2 years	7.5 years

The weighted-average grant-date fair value of each option granted during 1997, 1996 and 1995 was \$5.65, \$3.45 and \$4.16.

### NOTE 15. Shareowners' Equity

**Common Stock Split** - On January 30, 1998, the Board of Directors of SBC (Board) declared a two-for-one stock split, effected in the form of a stock dividend, on the shares of SBC's common stock. Each shareholder of record on February 20,

1998 will receive an additional share of common stock for each share of common stock then held. The stock will be issued March 19, 1998. SBC will retain the current par value of \$1.00 per share for all shares of common stock.

**Shareowners' Rights Plan** - The Shareowners' Rights Plan (Plan) becomes operative in certain events involving the acquisition of 20% or more of SBC's common stock by any person or group in a transaction not approved by the Board, or the designation by the Board of a person or group owning more than 10% of the outstanding stock as an adverse person, as provided in the Plan. Upon the occurrence of these events, each right, unless redeemed by the Board, generally entitles the holder (other than the holder triggering the right) to purchase an amount of common stock of SBC (or, in certain circumstances, of the potential acquiror) having a value equal to two times the exercise price of \$160. The rights expire in January 1999. After giving effect to stock splits in January 1998 and May 1993, effected in the form of a stock dividend, each share of common stock represents one-quarter of a right.

The rights have certain antitakeover effects. The rights will cause substantial dilution to a person or group that attempts to acquire SBC on terms not approved by the Board.

The rights should not interfere with any merger or other business combination approved by the Board since the rights may be redeemed.

### NOTE 16. Acquisitions and Dispositions

In May 1997, a consortium made up of SBC and Telekom Malaysia Berhad, 60% owned by SBC, completed the purchase of 30% of Telkom SA Limited (Telkom), the state-owned telecommunications company of South Africa. SBC invested \$760, approximately \$600 of which will remain in Telkom.

In October 1995, SBC combined its United Kingdom cable television operations with those of TeleWest Communications, P.L.C., a publicly held joint venture between Telecommunications, Inc. and U S WEST, Inc. The resulting entity, TeleWest P.L.C. (TeleWest), is the largest cable television operator in the United Kingdom. SBC owns approximately 15% of the new entity and accounts for its investment using the cost method of accounting. Restrictions expiring over the next three years exist on the sale of SBC's interest in TeleWest. SBC recorded an after-tax gain of \$111 associated with the combination.

During 1995, SBC purchased at auction PCS licenses in Los Angeles-San Diego, California; San Francisco-Oakland-San Jose, California; Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma for approximately \$769. During 1996, SBC received several AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis and Little Rock and other consideration.

These acquisitions were primarily accounted for under the purchase method of accounting. The purchase prices in excess of the underlying fair value of identifiable net assets acquired are being amortized over periods not to exceed 40 years. Results of operations of the properties acquired have been included in the consolidated financial statements from their respective dates of acquisition.

The above developments did not have a significant impact on consolidated results of operations for 1997 or 1995, nor would they had they occurred on January 1 of the respective periods.

**NOTE 17. Additional Financial Information**

	December 31,		
Balance Sheets	1997	1996	
Accounts payable and accrued liabilities			
Accounts payable	\$2,848		\$2,741
Accrued taxes	1,108		893
Advance billing and customer deposits	699		611
Compensated future absences	524		479
Accrued interest	306		279
Accrued payroll	315		194
Other	2,088		1,387
Total	\$7,888		\$6,584
<hr/>			
Statements of Income	1997	1996	1995
Interest expense incurred	\$1,067	\$ 948	\$1,000
Capitalized interest	(120)	(136)	(43)
Total interest expense	\$ 947	\$ 812	\$ 957
<hr/>			
Allowance for funds used during construction	-	-	\$ 48
<hr/>			
Statements of Cash Flows	1997	1996	1995
Cash paid during the year for:			
Interest	\$ 920	\$ 799	\$ 974
Income taxes	\$ 410	\$1,283	\$1,220

**NOTE 18. Quarterly Financial Information (Unaudited)**

Calendar Quarter	Total Operating Revenues <sup>(4)</sup>	Operating Income (Loss)	Net Income (Loss)	Basic Earnings (Loss) per Common Share <sup>(3)</sup>	Stock Price <sup>(5)</sup>		
					High	Low	Close
1997							
First <sup>(1)</sup>	\$ 5,973	\$1,586	\$ 857	\$ 0.47	\$29.125	\$24.813	\$26.250
Second <sup>(1)</sup>	5,921	(933)	(787)	(0.43)	30.938	24.625	30.938
Third <sup>(1)</sup>	6,329	1,472	816	0.45	31.125	26.781	30.719
Fourth <sup>(1)</sup>	6,633	1,045	588	0.32	38.063	30.000	36.625
Annual <sup>(1)</sup>	\$24,856	\$3,170	\$1,474	\$ 0.81			
1996							
First <sup>(2)</sup>	\$ 5,564	\$1,458	\$ 888	\$ 0.48	\$30.125	\$24.875	\$26.313
Second	5,731	1,489	803	0.44	25.375	23.125	24.625
Third	5,948	1,532	867	0.47	25.500	23.000	24.063
Fourth	6,202	1,357	721	0.39	27.625	23.500	25.938
Annual <sup>(2)</sup>	\$23,445	\$5,836	\$3,279	\$ 1.78			

<sup>(1)</sup>Net income (loss) includes \$90 first quarter pension settlement gain for 1996 retirements (see Note 12), \$1.6 billion second quarter charges related to post-merger initiatives (see Note 3), \$43 and \$360 of third and fourth quarter merger integration costs and customer number portability expenses and \$33 fourth quarter gain on sale of SBC's interests in Bell Communications Research, Inc.

<sup>(2)</sup>Net Income and Earnings per Common Share reflect a cumulative effect of accounting change of \$90 or \$0.05 per share from change in accounting for directory operations.

<sup>(3)</sup>Restated to reflect two-for-one stock split declared January 30, 1998. Stock prices have not been adjusted to reflect the merger with PAC.

<sup>(4)</sup>Quarterly information has been restated to conform to the current presentation of promotional discounts.

No customer accounted for more than 10% of consolidated revenues in 1997, 1996 or 1995.

Several subsidiaries of SBC have negotiated contracts with the Communications Workers of America (CWA). Approximately 67% of SBC's employees are represented by the CWA. Contracts covering an estimated 77,000 employees between the CWA and several SBC subsidiaries end in 1998. New contracts are scheduled to be negotiated in 1998.

## REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Shareowners  
SBC Communications Inc.

We have audited the accompanying consolidated balance sheets of SBC Communications Inc. (the Company) as of December 31, 1997 and 1996, and the related consolidated statements of income, shareowners' equity, and cash flows for each of the three years in the period ended December 31, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the 1996 and 1995 financial statements of Pacific Telesis Group, a wholly-owned subsidiary, which statements reflect total assets constituting 42% of the Company's related 1996 consolidated financial statement total and which reflect total operating revenues constituting approximately 41% and 42% of the Company's related consolidated financial statement totals for the years ended December 31, 1996 and 1995, respectively. Those statements were audited by other auditors whose report, which has been furnished to us, included an explanatory paragraph that describes the change in its method of recognizing directory publishing revenues and related expenses, and the discontinuance of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation." Our opinion, insofar as it relates to the 1996 and 1995 data included for Pacific Telesis Group, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and, for 1996 and 1995, the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of SBC Communications Inc. at December 31, 1997 and 1996, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, Pacific Bell, a subsidiary of Pacific Telesis Group, changed its method of recognizing directory publishing revenues and related expenses effective January 1, 1996. As discussed in Note 2 to the consolidated financial statements, SBC Communications Inc. discontinued its application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" in 1995.

*Ernst & Young LLP*

San Antonio, Texas  
February 20, 1998

## REPORT OF MANAGEMENT

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles. The integrity and objectivity of the data in these financial statements, including estimates and judgments relating to matters not concluded by year end, are the responsibility of management, as is all other information included in the Annual Report, unless otherwise indicated.

The financial statements of SBC Communications Inc. (SBC) have been audited by Ernst & Young LLP, independent auditors. Management has made available to Ernst & Young LLP all of SBC's financial records and related data, as well as the minutes of shareowners' and directors' meetings. Furthermore, management believes that all representations made to Ernst & Young LLP during its audit were valid and appropriate.

Management has established and maintains a system of internal accounting controls that provides reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition and the prevention and detection of fraudulent financial reporting. The concept of reasonable assurance recognizes that the costs of an internal accounting controls system should not exceed, in management's judgment, the benefits to be derived.

Management also seeks to ensure the objectivity and integrity of its financial data by the careful selection of its managers, by organizational arrangements that provide an appropriate division of responsibility and by communication programs aimed at ensuring that its policies, standards and managerial authorities are understood throughout the organization. Management continually monitors the system of internal accounting controls for compliance. SBC maintains an internal auditing program that independently assesses the effectiveness of the internal accounting controls and recommends improvements thereto.

The Audit Committee of the Board of Directors, which consists of eight directors who are not employees, meets periodically with management, the internal auditors and the independent auditors to review the manner in which they are performing their responsibilities and to discuss auditing, internal accounting controls and financial reporting matters. Both the internal auditors and the independent auditors periodically meet alone with the Audit Committee and have access to the Audit Committee at any time.

*Edward E. Whitacre Jr.*

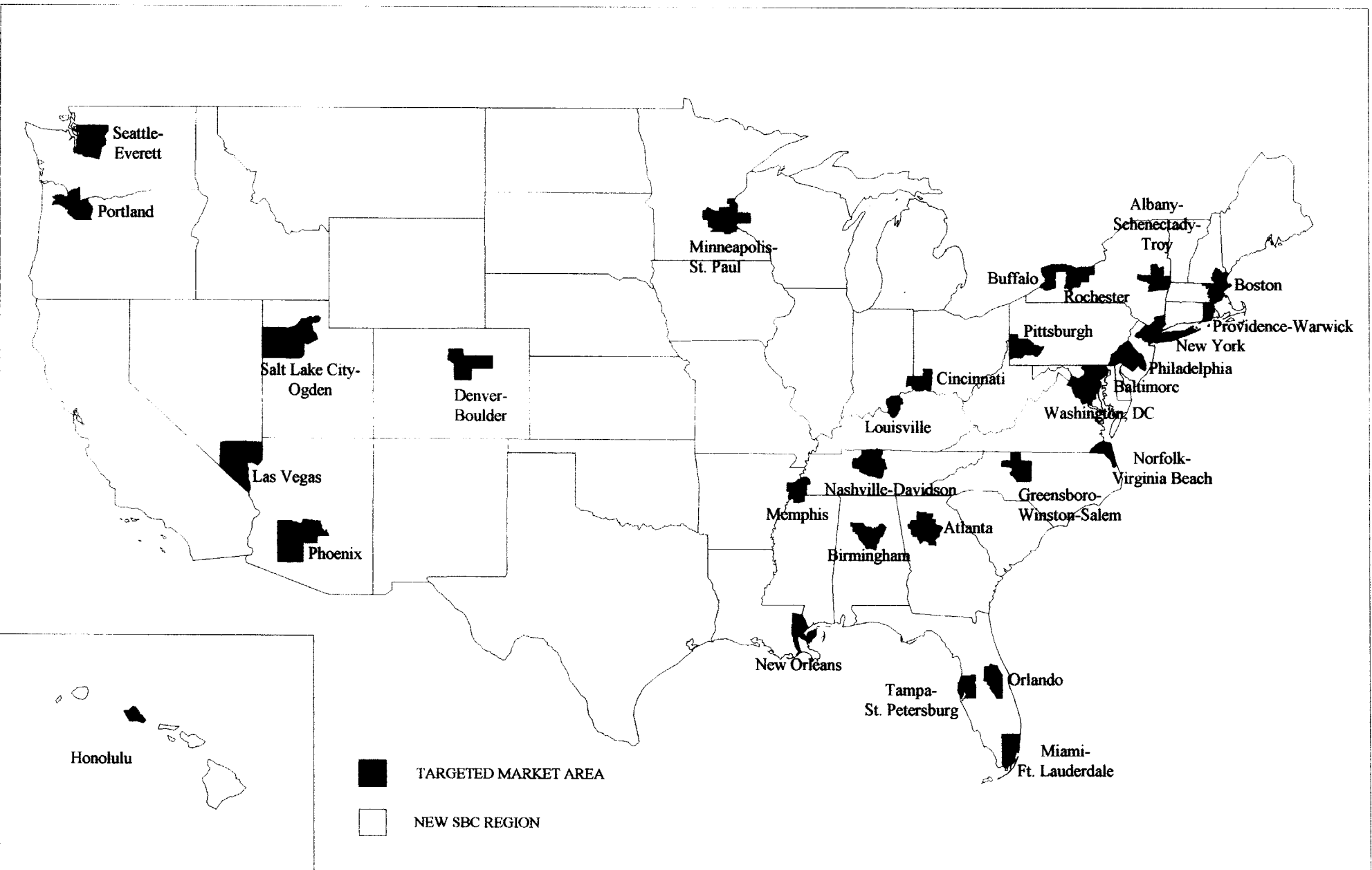
Edward E. Whitacre Jr.  
Chairman of the Board and  
Chief Executive Officer

*Donald E. Kiernan*

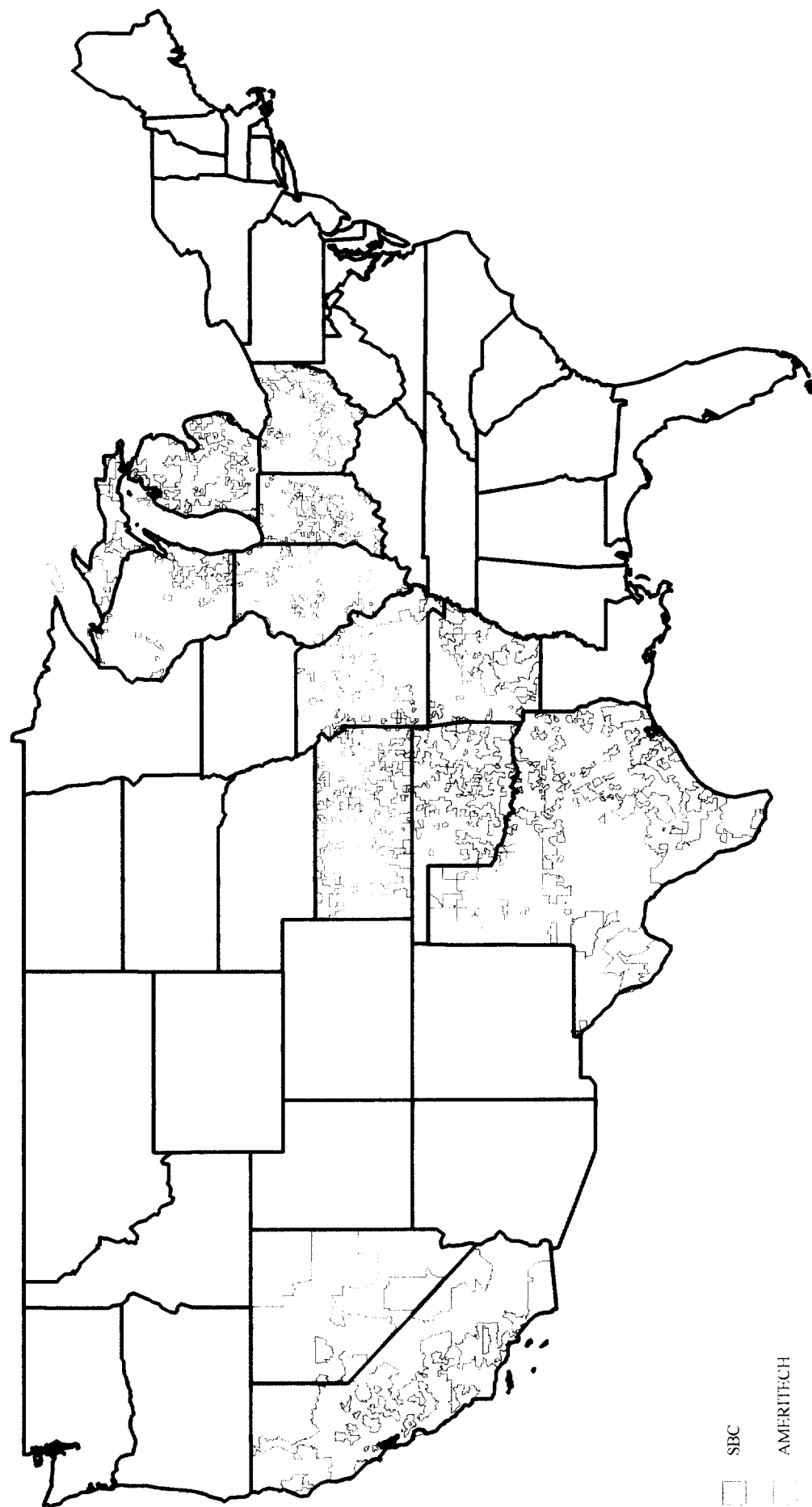
Donald E. Kiernan  
Senior Vice President, Treasurer  
and Chief Financial Officer



**Map 1. 30 Markets Targeted for SBC's "National-Local" Strategy**

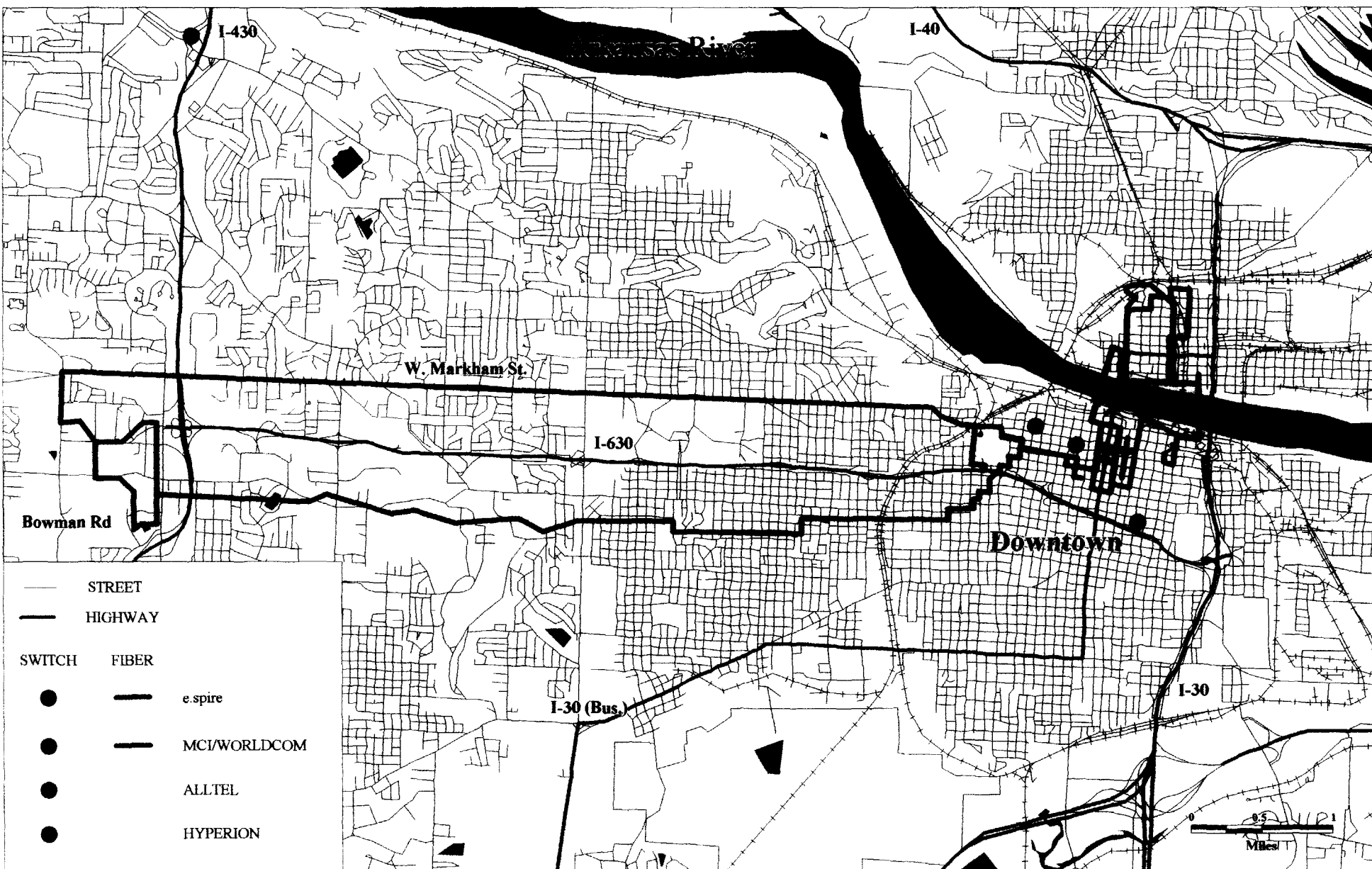


**Map 2. SBC and Ameritech Local Service Areas**

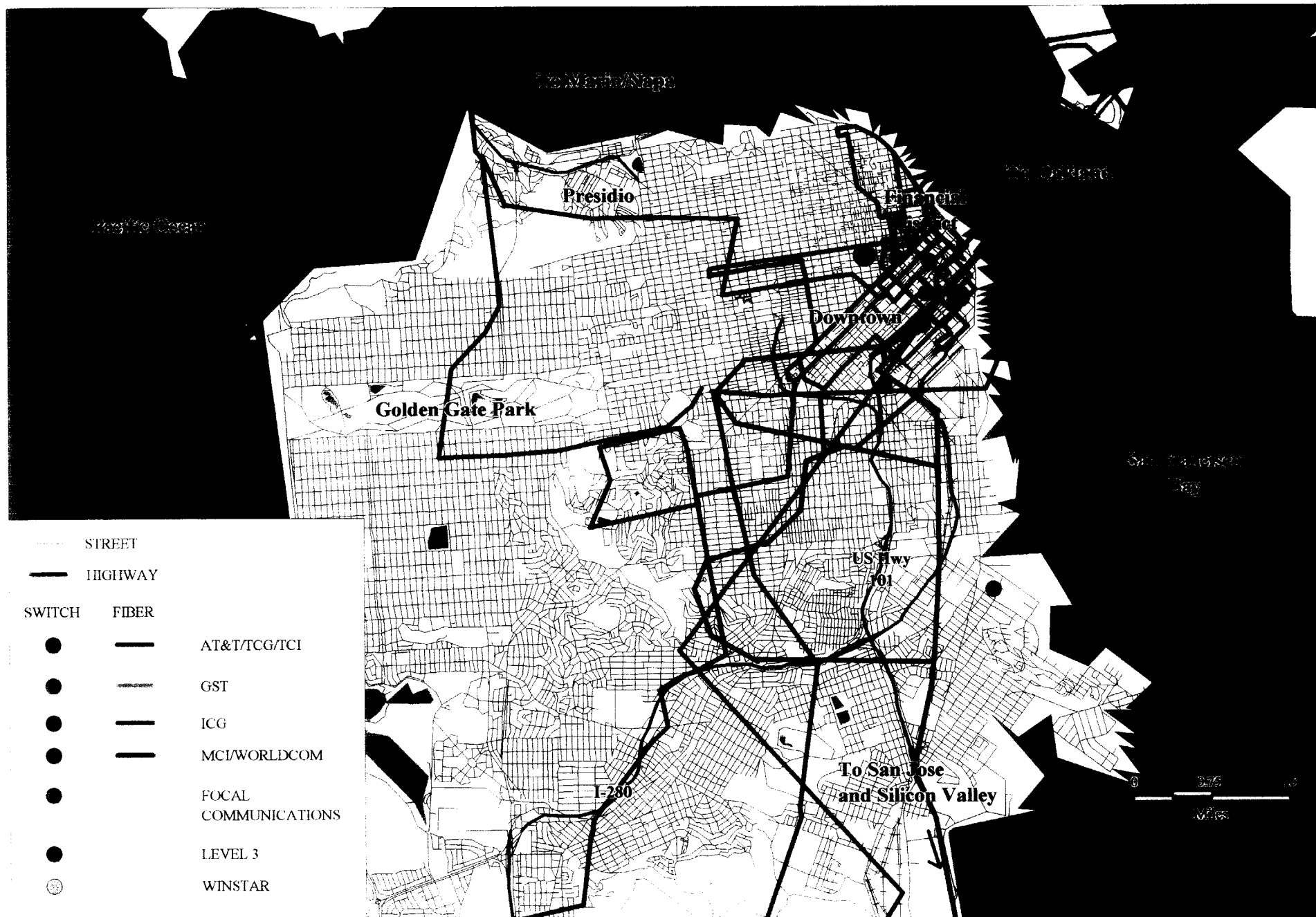




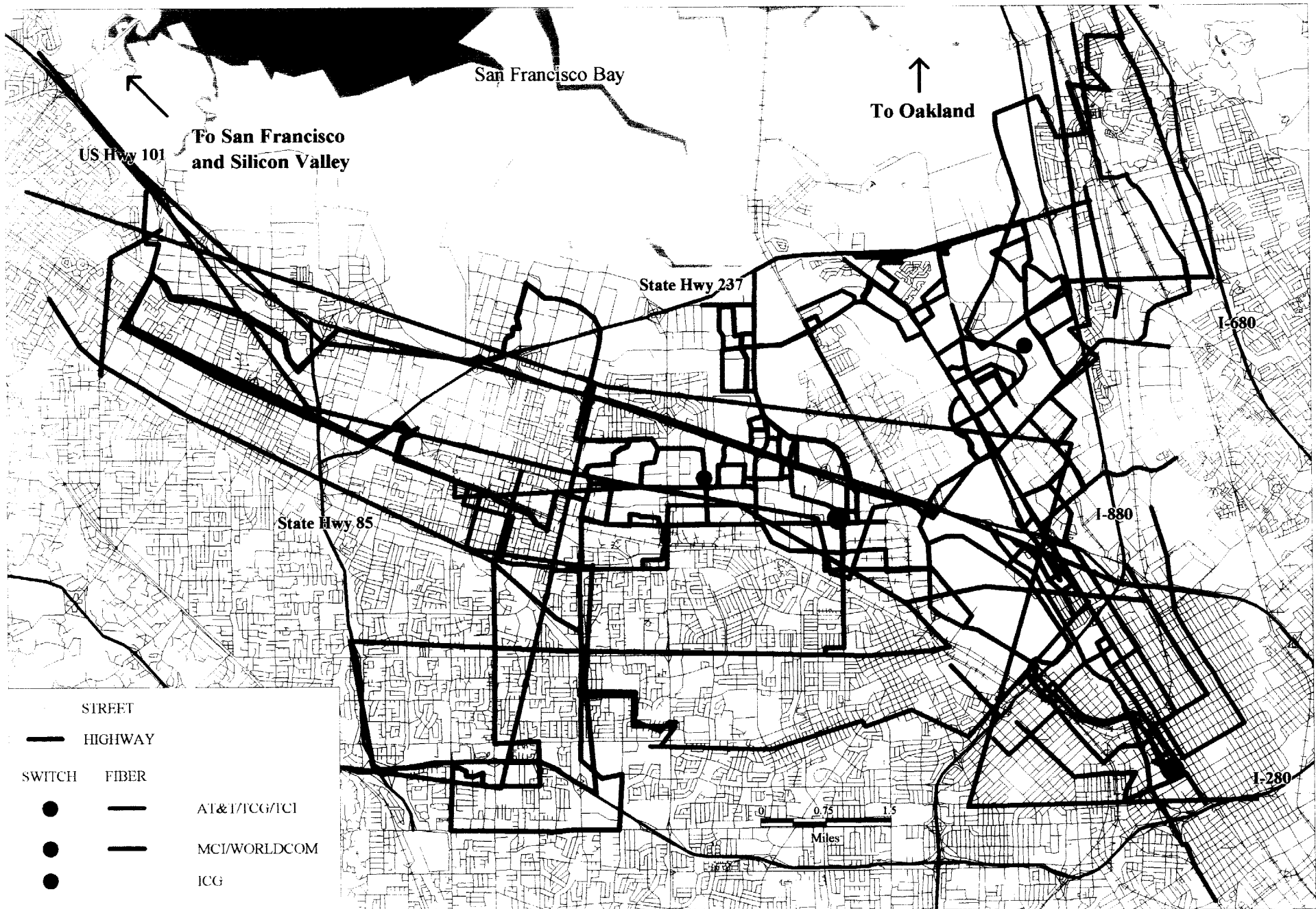
# Map 3. Competitive Networks - Little Rock, AR



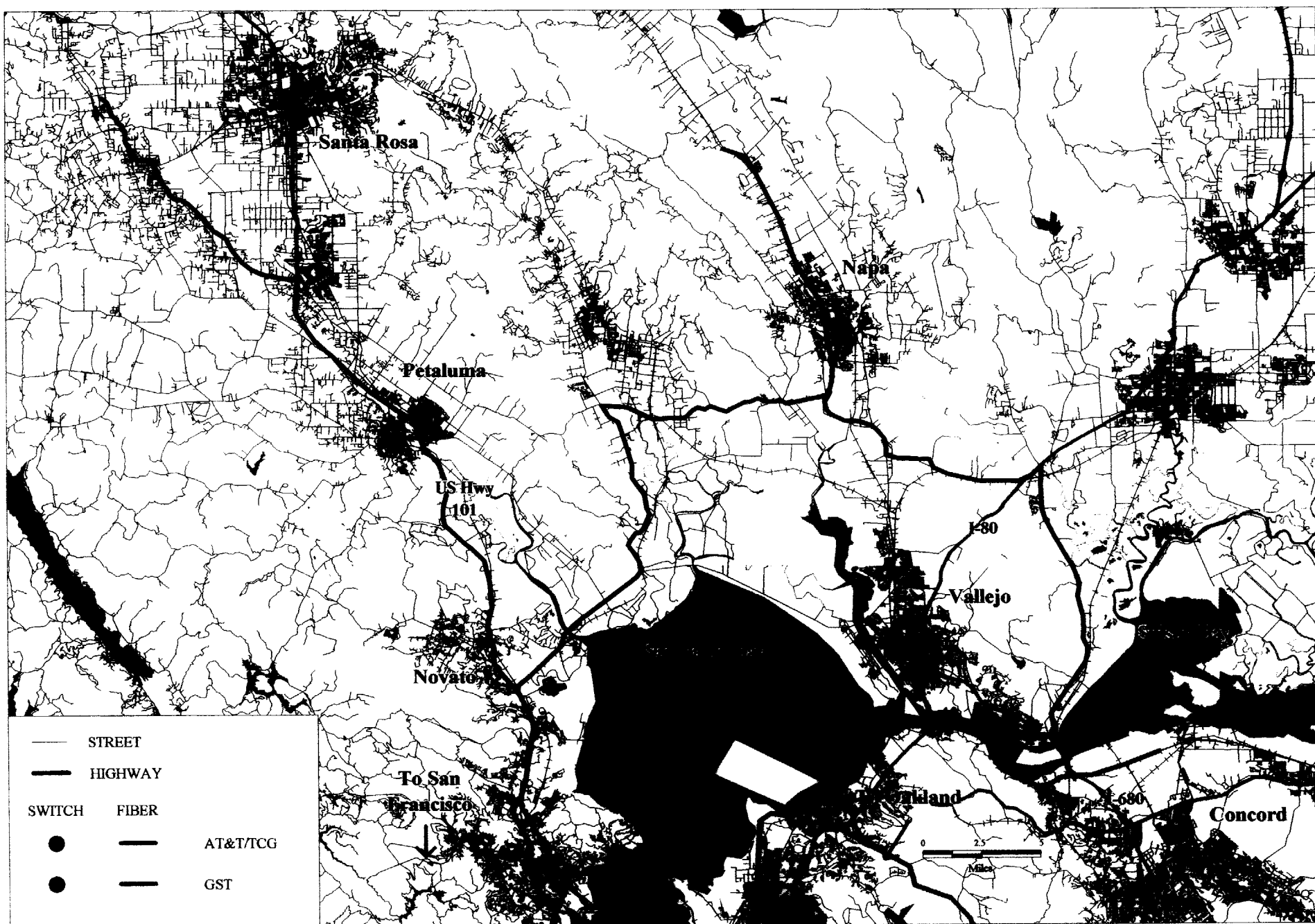
### Map 4. Competitive Networks - San Francisco, CA



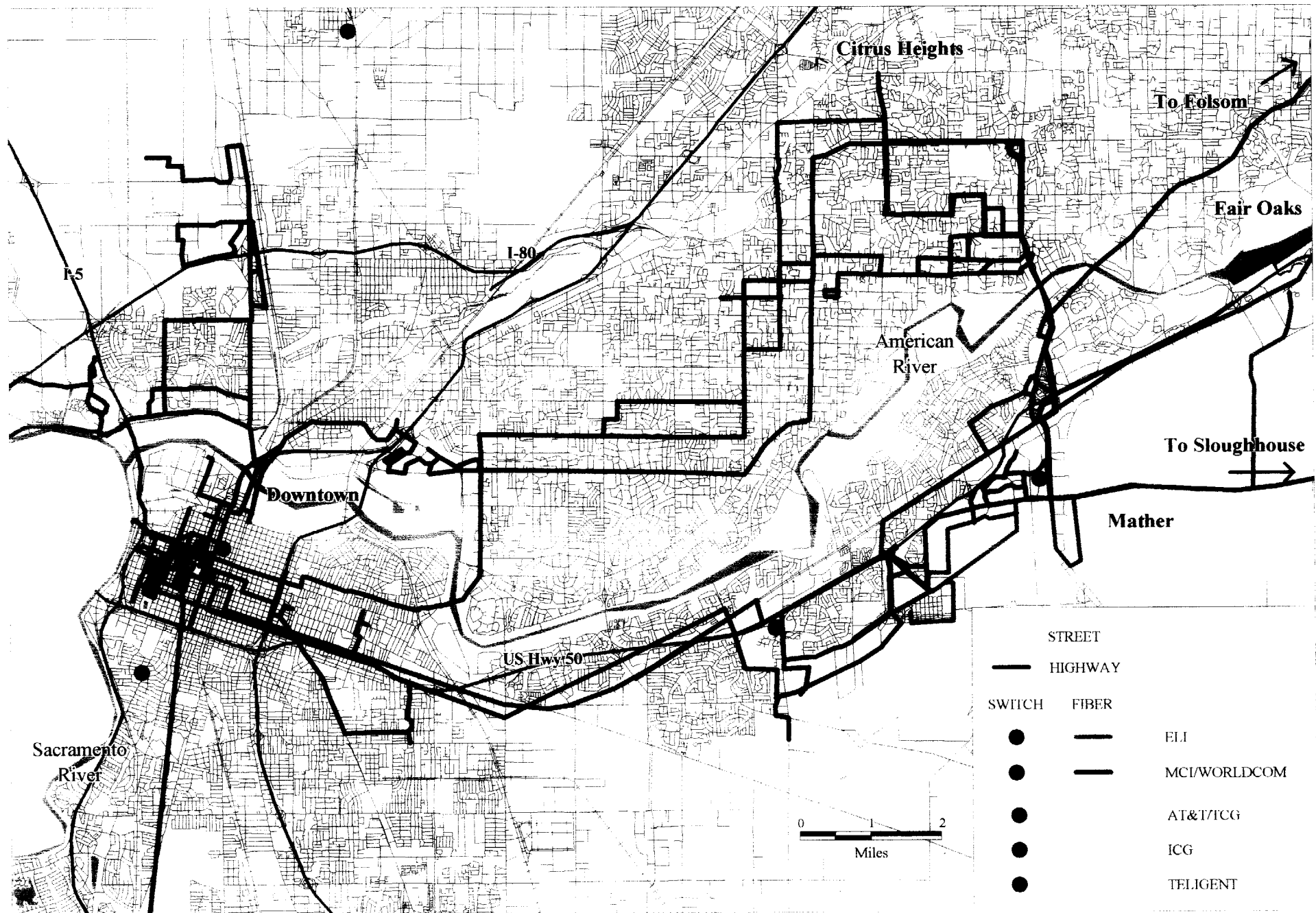
# Map 5. Competitive Networks - San Jose, CA



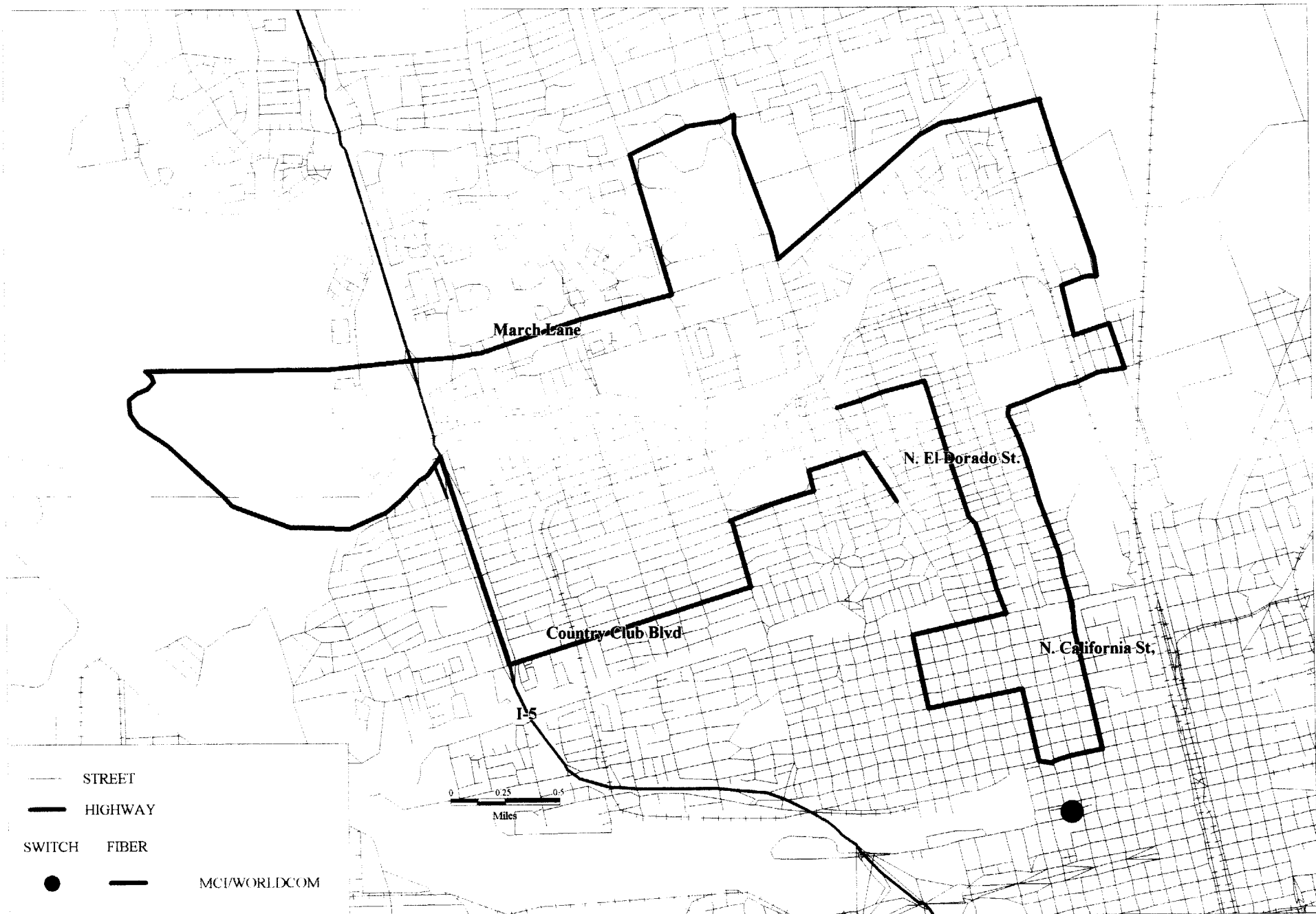
# Map 6. Competitive Networks - Petaluma/Napa, CA



# Map 7. Competitive Networks - Sacramento, CA

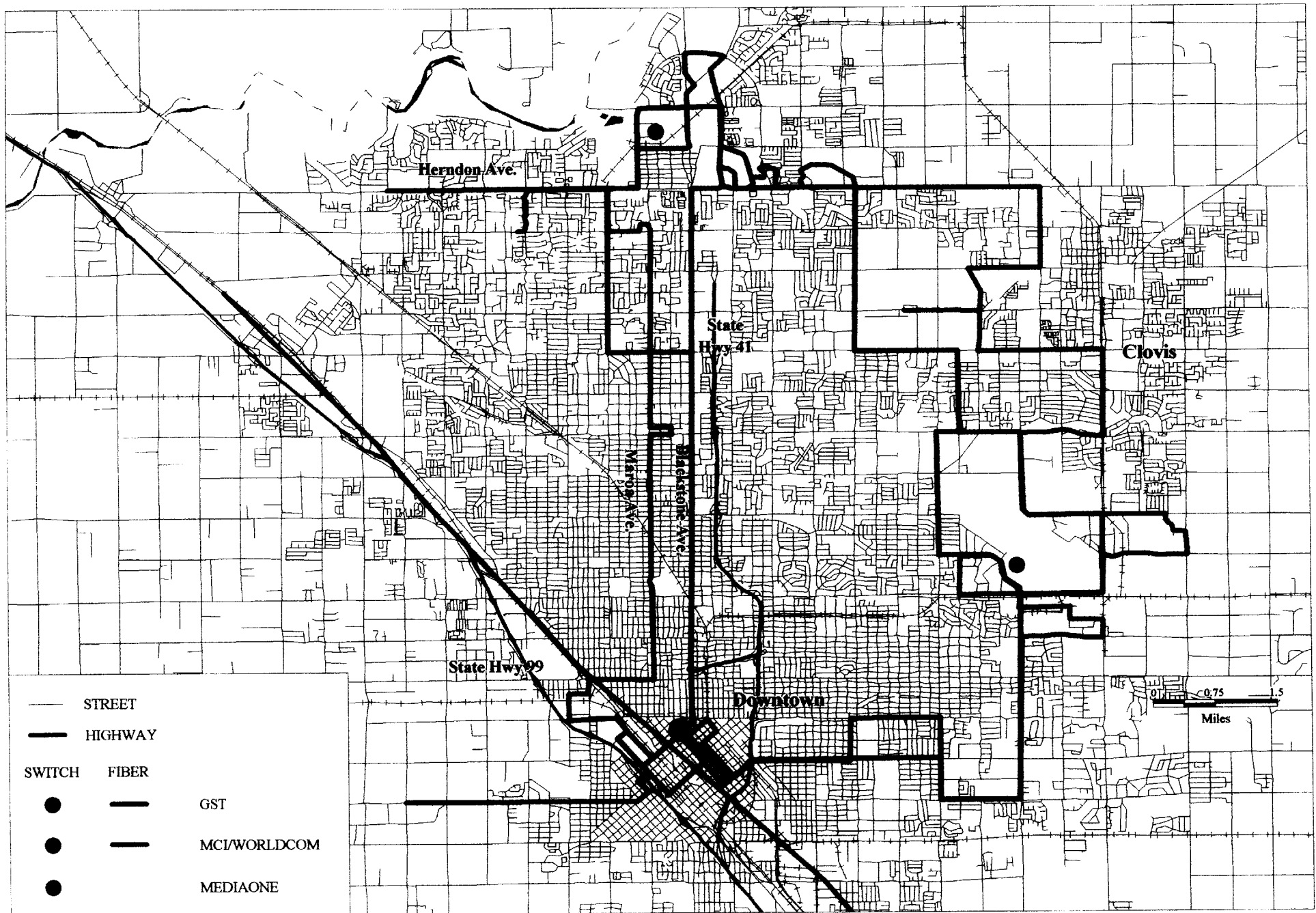


# Map 8. Competitive Networks - Stockton, CA



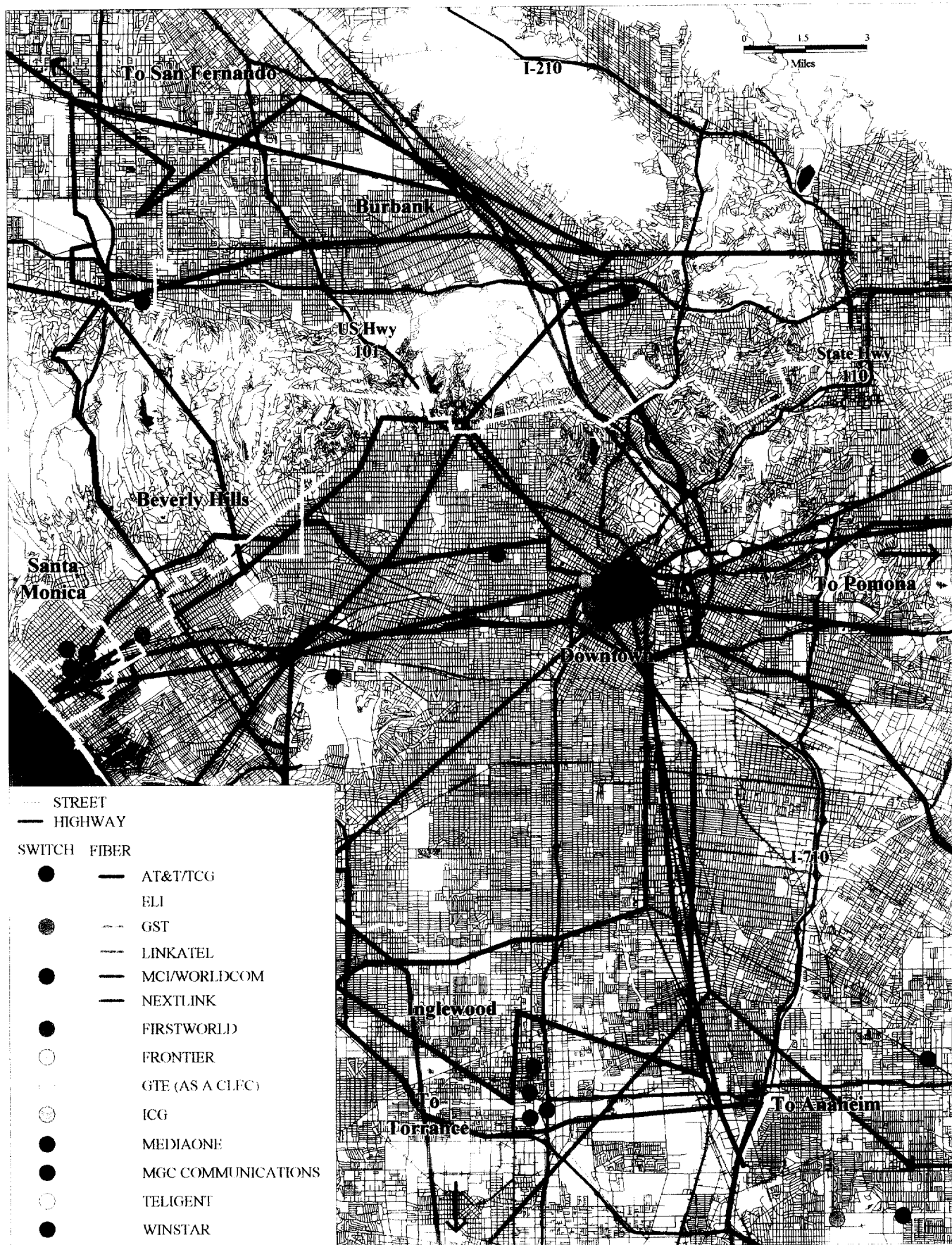


# Map 9. Competitive Networks - Fresno, CA

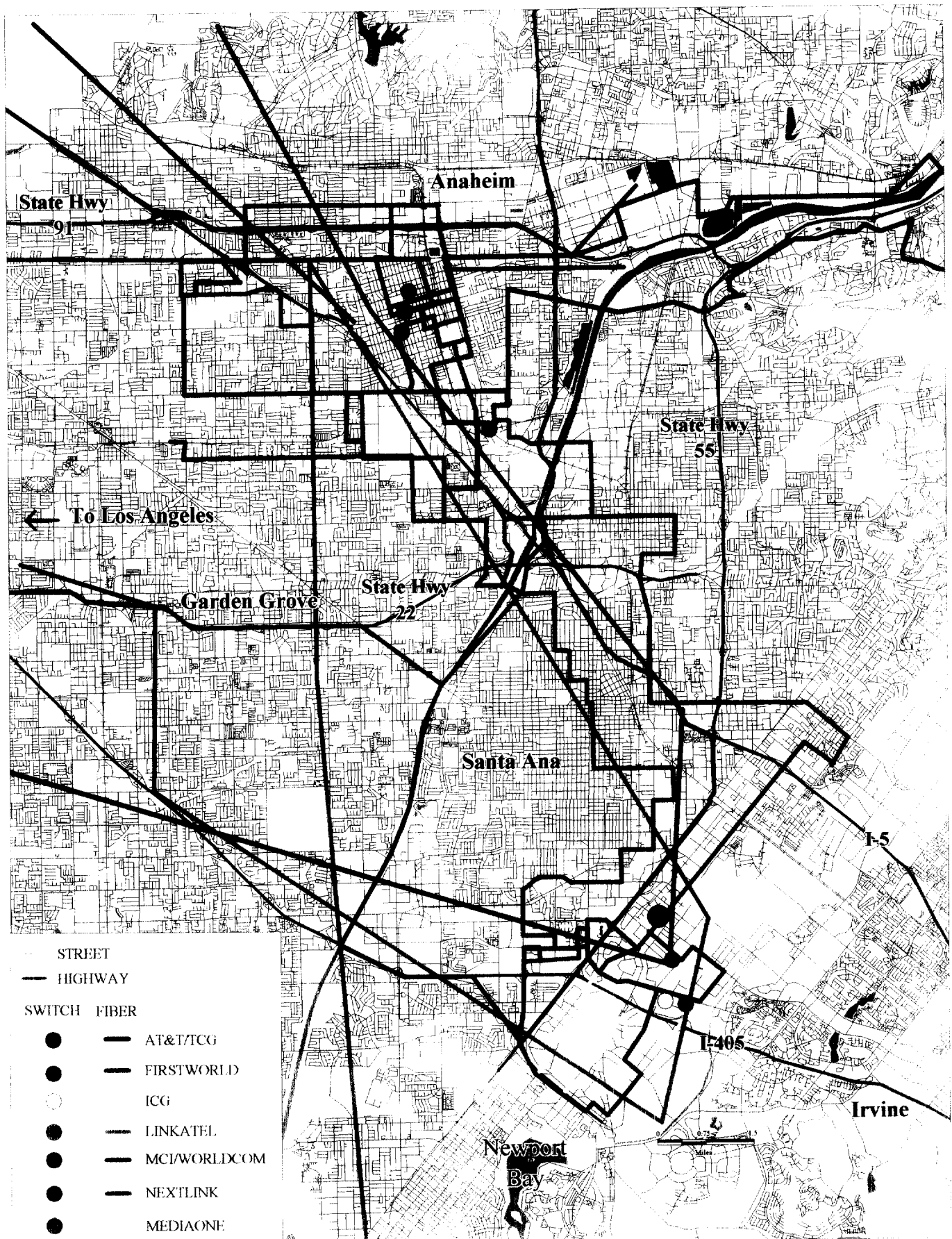




# Map 10. Competitive Networks - Los Angeles, CA



# Map 11. Competitive Networks - Anaheim, CA



# Map 12. Competitive Networks - San Diego, CA

